



**SHADOW
FINANCIAL
REGULATORY
COMMITTEE**

COMMITTEE MEMBERS

GEORGE G. KAUFMAN
Co-Chair
Loyola University Chicago

RICHARD J. HERRING
Co-Chair
University of Pennsylvania

GEORGE J. BENSTON
Emory University

MARSHALL E. BLUME
University of Pennsylvania

CHARLES CALOMIRIS
Columbia University

KENNETH W. DAM
University of Chicago Law School

ROBERT A. EISENBEIS
Banking Consultant

PAUL M. HORVITZ
University of Houston

EDWARD J. KANE
Boston College

ROBERT E. LITAN
Brookings Institute and
Kauffman Foundation

KENNETH E. SCOTT
Stanford Law School

PETER J. WALLISON
American Enterprise Institute

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 243

For Information Contact:

Robert A. Eisenbeis
770-416-0047

Charles W. Calomiris
212-854-8748

Statement of the Shadow Financial Regulatory Committee on

The SEC's Proposed Prohibition of Notching

May 7, 2007

Congress has sought to lower barriers to entry to the ratings industry. To achieve this result, Congress mandated that the Securities and Exchange Commission (SEC) simplify its criteria for recognizing and registering rating agencies as nationally recognized statistical rating organizations (NRSROs). The simplification of the criteria for qualifying as an NRSRO would, in the Shadow Financial Regulatory Committee's opinion, succeed in lowering the threshold entry requirements. We applaud this reduction in regulatory barriers to entry for new rating agencies.

Congress has also mandated that the SEC should not concern itself with methodologies the NRSROs use to reach their conclusions. In lowering the barriers to entry, Congress intended that market participants should form their own judgments about the quality of ratings issued by different NRSROs.

However, the SEC has proposed (in Proposed Rule 17g-6(a)(4)), as part of its "Proposed Rules Implementing Provisions of the Credit Rating Agency Reform Act of 2006," to modify the circumstances under which an NRSRO may refuse to rate different tranches of collateralized debt obligations (CDOs). The SEC has specified conditions where an NRSRO may refuse to rate the CDO when it has not rated all of the underlying assets in the pool. The language of the particular proposal clearly indicates that an NRSRO may either refuse to rate or lower (or "notch") the rating of another agency when it has rated less than 85 percent of the underlying assets. However, when an agency has rated 85 percent or more of the underlying assets the proposal states that the NRSRO may not refuse to rate the CDO, but the rule is unclear whether

An independent committee
sponsored by the
American Enterprise Institute

<http://www.aei.org>

“notching” the ratings of another agency is also prohibited. Many commentators have read the SEC as indicating that “notching” would be prohibited in some or all circumstances and thus, the NRSRO would effectively be required to accept the rating of another agency in these instances.

The Shadow Committee believes there would be no justification for such an exception and that the language and intent of the rule as it pertains to “notching” should be clarified to permit the NRSRO to determine the methodologies by which they reach their rating opinions in all instances. Prohibiting “notching” would fail to recognize that there are legitimate reasons for differences in the quality of ratings by different NRSROs. By forcing some rating agencies to use the ratings of others in unchanged form, the SEC would erase these important market-recognized differences that should legitimately be reflected in securities prices.